No. 93-714 (14)

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In The

Supreme Court of the United States

October Term, 1993

U.S. BANCORP MORTGAGE COMPANY,

Petitioner,

v.

BONNER MALL PARTNERSHIP,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

MOTION FOR LEAVE TO FILE A BRIEF AS AMICUS CURIAE AND BRIEF OF THE AMERICAN COLLEGE OF REAL ESTATE LAWYERS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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MOTION FOR LEAVE TO FILE A BRIEF AS AMICUS CURIAE

The American College of Real Estate Lawyers ("ACREL") by and through their undersigned attorney hereby respectfully moves this Court for leave to file the attached *amicus curiae* brief in support of U.S. Bancorp Company (the "Petitioner") in the above captioned matter (the "Appeal") and respectfully represent as follows:

Consent of Parties

The consent of the attorney for the Petitioner has been obtained. A letter evidencing such consent is attached hereto as exhibit A. The consent of the attorney for the Respondent was requested but refused.

Interest of the Amicus Curiae

I. ACREL is a non-profit corporation organized for the purpose of gathering together lawyers to improve and reform real estate law. ACREL's membership consists of approximately 800 attorneys from nearly ever state and the District of Columbia who have concentrated their practice in real estate law for a period of ten years or more, and law professors specializing in the field of real estate law. The case at bar involves a single asset debtor owning commercial real estate.

II. ACREL believes that the decision of the Ninth Circuit, if upheld, will have serious adverse affects upon the availability of financing for the acquisition and development of commercial real property in the United States.

III. ACREL therefore has an interest in presenting to the Court the view that in the broad context of public policy and future economic development, the interpretation of the Bankruptcy Code advanced by the Ninth Circuit is erroneous and should be overruled.

The Proposed Amicus Curiae Brief

IV. A copy of the proposed *amicus curiae* brief is submitted herewith. The proposed brief focuses on legal and policy arguments not made in the brief of the Petitioner.

Conclusion

Due to the *Amicus'* substantial interest in the outcome of the Appeal and due to the importance of the issues presented, the *Amicus* hereby requests that their

motion for leave to file an *amicus curiae* brief in the Appeal be granted.

Dated: New York, New York
February 22, 1994

Respectfully submitted,

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BRIEF OF THE AMERICAN COLLEGE OF REAL ESTATE LAWYERS AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

QUESTION PRESENTED

1. Whether the "new value exception" to the "absolute priority rule" survived the codification of a modified absolute priority rule under §1129(b)(2)(B)(ii) of the Bankruptcy Code, which does not reflect such exception?

2. Assuming, *arguendo*, the existence of a "new value exception" did the Ninth Circuit properly apply such exception?

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STATEMENT OF INTEREST OF AMICUS CURIAE

The American College of Real Estate Lawyers ("ACREL") is a nonprofit corporation, organized for the purpose of, *inter alia*, gathering together lawyers "to improve and reform real estate law and practice." (ACREL Articles of Incorporation at 2). ACREL's membership consists of over 800 attorneys from nearly every state and the District of Columbia who have concentrated their practice in real estate law for a period of ten years or more and law school professors specializing in the field of real estate law. In addition, members elected to ACREL must have demonstrated a willingness to devote time to improving real property law through writing, teaching or participation in professional association activities. ACREL's membership represents the entire spectrum of the real estate industry including borrowers, lenders, investors and developers. The case at bar – like almost all cases under the 1978 Bankruptcy Code involving the applicability of a "new value exception" to the present Bankruptcy Code's requirements for confirmation of a plan notwithstanding creditor rejection – involves a single asset debtor owning commercial real estate that has declined in value to a point where the debtor's real estate is worth less than the amount of secured debt on the property. ACREL is therefore in a position to offer an unbiased and knowledgeable opinion as to the proper resolution of the issues now before this Court.

This brief supports the position of the Petitioner in this case. Due to the background of the Amicus and its experience as counsel to lenders and borrowers, it is in a unique position to offer its expertise to this Court concerning the adverse effects caused by an affirmance of the

decision below on the availability of financing for the acquisition and development of commercial real property in the United States.

SUMMARY OF ARGUMENT

The Court of Appeals' decision in *In re Bonner Mall* upholding the application of the "new value exception" to the absolute priority rule is contrary to the express language of §1129(b)(2)(B) of the Bankruptcy Code and the intention of Congress. Nothing in the express language of the Bankruptcy Code supports the Ninth Circuit's conclusion that the "new value exception" survived enactment of the Bankruptcy Code in 1978 and, in fact, the plain language of §1129(b)(2)(B) controverts such a conclusion.

Even assuming, *arguendo,* that the "new value exception" is still viable, the Ninth Circuit's decision nevertheless should be reversed, as the Ninth Circuit's application of the exception is a distortion of the traditional "new value exception" for operating businesses created by this Court in *Case v. Los Angeles Lumber.* This distortion arises from the application of the "new value exception" to a single asset real estate plan, which would allow the debtor and its principals to keep the assets of the enterprise without compensating unsecured creditors, thus abrogating the absolute priority requirements of the Bankruptcy Code. In addition, the Ninth Circuit's articulation of the "new value exception" violates the express

provisions of §1129(b)(2) of the Bankruptcy Code by preventing both secured and unsecured creditors from receiving the allowed amount of their claims.

As a final matter, the public policy rationale for the application of the "new value exception", which is based on the desire to maintain the going concern's value of the debtor's business and to keep people employed, is inapplicable in the single asset real estate context because the commercial real estate involved will continue in operation – only the ownership will change. Thus, there is no public policy rationale to uphold the application of the "new value exception" in the instant case.

ARGUMENT

I. "New Value Exception" Does Not Survive the Enactment of the Bankruptcy Code.

A. Relevant Statutes.

Nothing in the language of the Bankruptcy Code supports the Ninth Circuit's conclusion that the new value "exception" survived the enactment of the Bankruptcy Code. The Bankruptcy Code contains extensive provisions governing confirmation of plans of reorganization by the Bankruptcy Courts. 11 U.S.C. §1129.

Section 1129(b) of the Bankruptcy Code* details the limited circumstances under which a Bankruptcy Court may confirm – or "cramdown" – a plan even if a class of

* 11 U.S.C. §101 et seq. All section references are to the Bankruptcy Code.

creditors has not voted to accept the plan in accordance with §1129(a)(8).[1] Under this section, such a plan may be confirmed despite the non-acceptance of a creditor class "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. §1129(b)(1). Unlike the prior Bankruptcy Act, §1129(b) proceeds to define "fair and equitable" with respect to particular classes that have not accepted the plan. Congress chose not to include any "new value exception" in such definition. Section 1129(b)(2)(B) requires that for a plan to be "fair and equitable" with respect to a non-accepting class of unsecured claims

[1] Pursuant to §1129(a)(8) of the Bankruptcy Code, each class of claims or interests must either vote to "accept" the plan or not be "impaired" under the plan. *See generally* 11 U.S.C. §1124. Very few bankruptcy cases involve a situation where a class of unsecured creditors is not impaired under a plan. Pursuant to §1126 of the Bankruptcy Code, a class of creditors is deemed to have accepted a plan if such plan has been accepted by creditors that hold at least two thirds in amount and more than one half in number of the allowed claims of such class held by creditors that have voted to accept or reject the plan. 11 U.S.C. §1126(c). In short, individual dissenting creditors in a class can be outvoted by similarly situated creditors thus making possible confirmation of a plan that has been accepted by the requisite majorities. Significantly, the Bankruptcy Act of 1898, as amended by the Chandler Act of 1938, under which *Case v. Los Angeles Lumber* was decided, did not permit creditor majorities to accept a plan over the dissent of a single creditor in a class. (*See* discussion below).

(including a class containing a secured creditor's deficiency claim)[2] the plan must either (i) provide for full

[2] Pursuant to §1111(b)(1)(A), a deficiency claim of a nonrecourse lender is treated as a *recourse* unsecured claim against a debtor. The subsection provides in pertinent part:

> A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this Title, the same as if the holder of such claim had recourse against the debtor on account of such claim whether or not such holder has such recourse, unless
> –
>
> (i) the class of which such claim is a part elects, by at least two thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or
>
> (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

Indicative of Congressional intent is that fact that neither exception to this rule permits a debtor to maintain the property in question *and* pay the secured creditor less than the full amount of its claim.

Section 506(a) of the Bankruptcy Code provides that any such deficiency claim "is an unsecured claim". The section provides in pertinent part:

> "An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to set-off under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to set-off, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to set-off is less than the amount of such allowed claim." 11 U.S.C. §506(a).

Consequently, a deficiency claim of an undersecured creditor is accorded the treatment of an unsecured claim and is normally classified together with other unsecured claims.

payment on such claim or (ii) the holder of any claim or interest junior in priority to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property. 11 U.S.C. §1129(b)(2)(B) (emphasis added). As explained below, the statutes detailing confirmation and voting provisions do not contain any exception to this absolute priority rule in the case of a plan seeking confirmation over the non-acceptance of a creditor class. The "new value exception" to the absolute priority rule recognized by the Ninth Circuit below permits the owners of a debtor to retain the ownership of all the property of the debtor without paying in full the claims of the unsecured creditors – including the deficiency claims of secured creditors who would prefer to own the property and realize any later appreciation. The language of the Bankruptcy Code permits no such result.

There is no mention in the Bankruptcy Code of any exception to the clear and precise plan confirmation requirements of §1129(a) and §1129(b)(2)(B), which are unequivocal, without exception, and must be enforced as written. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241, (1989) (where the statute's language is plain the sole function of the court is to enforce it according to its terms) (quoting *Caminetti v. United States*, 242 U.S. 855 (1917)).

Indeed there is no reason for the "new value exception" to be applicable under the Bankruptcy Code since, as established below, the drafters of the Bankruptcy Code addressed and cured the problem giving rise to the adoption of the "new value exception".

B. Origin of the "New Value Exception" Under Prior Law.

The "new value exception" was judicially fashioned in response to the strict requirements of the corporate reorganization provisions of prior law, specifically §77B of the Bankruptcy Act of 1898 and its successor Chapter X of the Chandler Act of 1938. 5 Collier on Bankruptcy at 1100-1108, ¶ 1101.01[2] (Lawrence P. King ed. 1993). In order to protect individual dissenting creditors within accepting classes, it was provided that a plan could not be confirmed unless the plan was approved by the requisite majority of each class *and* judicially determined to be fair and equitable, *i.e.* met the absolute priority requirements.[3] As a result, notwithstanding approval of the plan by the requisite majorities of members of each class of creditors, a plan designed by senior creditors to motivate and keep effective management by giving the prior owners/managers an equity interest in the reorganized enterprise could not be confirmed if a single creditor objected.

In *Case v. Los Angeles Lumber Prod. Co.*, 308 U.S. 106 (1939), the debtor (with overwhelming creditor support) attempted to circumvent this strict rule by arguing that

[3] In short, in contrast to the present Bankruptcy Code confirmation requirements which are disjunctive, *viz.*, class acceptance *or* fair and equitable, the prior Bankruptcy Act requirements were conjunctive – class acceptance *and* fair and equitable. Under the present Bankruptcy Code, individual dissenting creditors are protected by, *inter alia*, the best interests of creditors test contained in 11 U.S.C. §1129(a)(7).

the old stockholders were paying for their retained interest in the reorganized entity by contributing their experience, contacts and management ability. This court rejected that argument stating that old equity could participate only if they paid for their interest in "money or money's worth" (*Id.* at 122). Thus this court created what became known as the "new value exception" to the absolute priority rule, under which junior interests (e.g. stockholders) could contribute new capital to a bankruptcy plan in exchange for an interest in the reorganized enterprise equal to the value of their contribution. Actually this is not an "exception" to the absolute priority rule, it is in fact an affirmation of the requirement of absolute priority and a rejection of attempts at "easy evasion of the principle of full or absolute priority" *Id.* (citations omitted)

Obviously, requiring payment of money for the interest was not the bargain that the senior creditors or old stockholders had in mind in the rejected plan in *Los Angeles Lumber.* They had agreed on equity participation without any payment. *Los Angeles Lumber's* "new value exception" did not solve the problem of the absolute priority rule permitting a single creditor to veto the plan approved by the requisite majorities of those who had an interest in the firm. When the Bankruptcy Code was being drafted, numerous suggestions were made for legislative changes that would deal with the problem by overcoming the rigid absolute priority requirements of Chapter X.

C. Congress Revises the Absolute Priority Rule.

On July 24, 1970, then President Nixon appointed the Commission on the Bankruptcy Laws of the United States ("Commission") to consider a review of the Bankruptcy Act. The Commission completed its work in July 1973 after an extensive study and submitted its Report ("Commission Report") containing a proposed new bankruptcy law. The Commission Report discussed the nature, development, justification and deficiencies of the absolute priority rule, noting that it had become a "straight jacket" since under it, equity security holders could not participate – even by agreement of all classes of creditors. Commission Report, Part I, at 256-57. The Commission's solution was to modify the absolute priority rule by permitting juniors who make a contribution important to the operation of the reorganized debtor to participate on a basis reasonably approximating the value of their contribution.[4]

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[4] The Commission Bill (H.R. Doc. No. 137, Parts I and II, Cong., 1st Sess. (1973) provided in §7-303(4) that the plan of reorganization:

> may provide, if the court finds that . . . certain partners or equity security holders will make a contribution which is important to the operation of the reorganized debtor or successor under the plan, for participation by the individual debtor, such partners, or such holders under the plan on a basis which reasonably approximates the value, if any, of their interests and the additional estimated value of such contribution.

This proposal created a storm of controversy[5] and was rejected by Congress. In its place, Congress modified the absolute priority rule in a different way, presently reflected in §1129 of the Bankruptcy Code, under which each class is free to agree by the requisite majority to accept a plan that affords the class less than absolute priority. Only where an impaired class rejects the plan is it entitled to absolute priority treatment. If §77B and Chapter X of the former Bankruptcy Act had contained a similar provision, the issue in *Los Angeles Lumber*, which gave rise to the creation of the "new value exception", would never have arisen.

Thus Congress dealt in a fundamental way with the problem for which the "new value exception" was developed. Senior classes of creditors are free to allow junior class participation if the senior class votes to accept such a plan. If a senior impaired class does not accept a plan, absolute priority must be provided or the plan cannot be confirmed as fair and equitable. *See* §1129(b)(2)(B)(ii). Any attempt to obviate the absolute priority requirements in court imposed plans (so-called "cramdown" plans) has no validity under the Bankruptcy Code as adopted by Congress.[6]

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[5] See e.g. Brudney, *The Bankruptcy Commission's Proposed "Modification" of the Absolute Priority Rule*, 48 Am. Bankr. L. J. 305, 337 (1974) and Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule of Corporate Reorganizations*, 87 Harv. L. Rev. 1786, 1817 (1974)

[6] Some courts have argued that this Court's decision in *Dewsnup v. Timm*, 112 S. Ct. 773 (1992) may require a finding that the new value "exception" survives the enactment of the Bankruptcy Code. This is not correct. While it is true as this Court stated in *Dewsnup* that Congress does not "write 'on a clean slate' " when it amends the bankruptcy laws, 112 S. Ct. at 779, no doctrine requires application of a pre-Code practice developed to meet a pre-Code requirement that no longer exists. As discussed above, it was the restrictive nature of the pre-Code absolute priority rule that resulted in the creation of the limited "new value exception". That restrictive nature has been removed from the Bankruptcy Code absolute priority provisions. Pre-Code practice cannot be said to survive into a new law that has eliminated the problem for which the practice was developed.

II. The Adoption of the "New Value Exception" by the Ninth Circuit and its Application to Single Asset Real Estate Reorganizations is a Distortion of the "New Value Exception" and Abrogates the Absolute Priority Requirements of the Bankruptcy Code.

As discussed above, given the Bankruptcy Code's extensive revisions to plan confirmation requirements, the "new value exception" has no *raison d'etre* in the Bankruptcy Code. Assuming *arguendo*, this Court concludes that the "new value exception" is still a viable judicial supplement to Chapter 11, or if this Court declines to reach the issue of the "exception's" validity[7], the Ninth Circuit should be reversed because the "new value exception" – as reformulated by the Ninth Circuit into the new value principle – is not the "new value exception" created by this Court in *Case v. Los Angeles Lumber*. In that decision, this Court concluded that a reorganization plan could permit a junior interest, with majority creditor consent, to participate in the reorganized entity only to the extent that the junior interest contributed money or money's worth to the enterprise.

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[7] *Norwest Bank Worthington v. Ahlers*, 485 U.S. at 203, n.3.

Such participation would not violate the absolute priority rule because in the context of a multi-asset reorganization, no creditor's interest was adversely affected by the retention of an interest in exchange for a contribution. The junior's contribution "enlarged the pie" of available assets and the junior was entitled to an interest to the extent its funds resulted in the enlargement. See Salvatore G. Gangemi and Stephen Bordanaro, *New Value Exception: Square Peg in a Round Hole,* 1 Am.Bankr.Inst.L.Rev. 173, 194 and n.130 (1993).

Under the Ninth Circuit's version of the "new value exception", by making a contribution, the debtor's principals can keep the property – free of the interests of unsecured creditors including the mortgagee's substantial deficiency claim. Instead of enabling the junior interest holder to participate to the extent it enlarges the "pie", the Ninth Circuit permits the junior interest to keep the property in question, and any subsequent appreciation to the detriment of all unsecured creditors and the mortgagee's deficiency claim. This is clearly contrary to the spirit, language and purpose of the "new value exception" and this Court's decision in *Los Angeles Lumber.*

The reason the Ninth Circuit's decision so distorts the "new value exception" is that the "exception" is being applied to a court imposed single asset real estate plan. As observed above, the "new value exception" arose in the context of multi-asset reorganizations where there was some value to be distributed to creditors. In a single asset court imposed plan such as the instant case, the debtor has only one property and that property is worth less than the debt to the mortgagee. The undersecured mortgage has been reduced under §1129(b)(2)(A) of the

Bankruptcy Code to the value of the collateral as determined under §506(a) of the Bankruptcy Code. Since, the plan reduces the secured creditor's mortgage to 100% of the previously court-determined property value, the debtor's principals argue that there is no equity for unsecured creditors. The self-serving alchemy of the plan is then invoked. Any "substantial" contribution, the debtor's principals argue, will be sufficient to enable them to keep the property and discharge the claims of unsecured creditors.[8]

This concept, that if there is no equity in the property, the creditors have no rights, was specifically rejected by this Court in *Northern Pacific Railway Co. v. Boyd,* 228 U.S. 482, 508 (1913) where this Court stated:

> "If the value of the [property] justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or *only for purposes of control.* In either event it was a *right of property* out of which the creditors were entitled to be paid before the stockholders could *retain it for any purpose whatever.*" (emphasis added.)

228 U.S. at 508.

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[8] The inequity of such a scheme is particularly apparent in the commercial real estate industry where property values are affected little by management expertise and cyclical fluctuations are common. The Ninth Circuit's approach shifts the downside risk to the lenders.

Control is a property right and whether or not the court finds equity in the property, the creditors are entitled to the benefit of that control. This principle is embodied within §1129(b)(2)(B) and was specifically endorsed by this court in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 207-09 (1989).[9]

The "new value exception" as reformulated and applied by the Ninth Circuit takes a rule designed to protect creditors and converts it to a rule under which the debtor and its principals can keep the assets of the enterprise without compensating unsecured creditors, thus abrogating the absolute priority requirements of §1129(b)(2)(B). This violates the Bankruptcy Code and rule of absolute priority rule as it has long been articulated by this Court.

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[9] *See also In re Outlook/Century Ltd.*, 127 B.R. 650, 656 (Bankr. N.D. Cal. 1991) where the court recognized that the plain language of §1129(b)(2)(B) does not permit any "new value exception":

> The 'new value exception' is inconsistent with the principle of creditor control, because it would permit Debtor to force the plan of reorganization on creditors who do not believe that the plan is in their best interest and whom Debtor does not propose to pay in full.

127 B.R. at 657-658 (citations omitted).

III. The Ninth Circuit's Application of the "New Value Exception" is Contrary to the Express Provisions of §1129(b)(2) of the Bankruptcy Code.

A. Under the "New Value Exception" as Articulated by the Ninth Circuit, the Holder of the Secured Claim Will Not Receive the Allowed Amount of its Claim as Required by §1129(b)(2)(A)(i) of the Bankruptcy Code.

Section 1129(b) of the Bankruptcy Code provides that where a dissenting, impaired class of creditors rejects a plan, the plan may be confirmed notwithstanding this rejection by a class only if the plan is "fair and equitable" as to that class. With respect to secured classes, under §1129(b)(2)(A)(i), where the dissenting, impaired secured creditor's lien is retained under the plan, the plan is not fair and equitable as to that class if the lien does not have a value as of the effective date of the plan equal to the amount of the secured claim.

The amount of an undersecured creditor's claim is determined under §506(a) which provides that a claim is a secured claim to the extent of the value of the collateral and an unsecured claim to the extent that the debt exceeds the value of the collateral. In the instant case, the value of the collateral was determined under §506(a) and the mortgage was reduced to that value. Section 506(a) is subject to redetermination for various purposes during the reorganization including a redetermination in connection with "any hearing . . . on a plan affecting such creditor's interest." 11 U.S.C. §506(a).

The best indicia of the value of real property is what a person will pay for the property. In the instant case the

debtor's plan proposes that certain of its partners acquire the property subject to a mortgage equal to 100% of the earlier §506(a) determined property value upon the payment of an additional $200,000. In other words, those partners are willing to buy the property for $200,000 in excess of the §506(a) value. This indicates that the earlier valuation is incorrect and that the amount of the allowed secured claim should be increased to at least the amount the debtor's principals are willing to pay for the property. Unless the secured claim is increased to that amount, the secured creditor is being deprived of its interest in the collateral contrary to the express provisions of §1129(b)(2)(A).[10]

B. Under the "New Value Exception" as Reformulated by the Ninth Circuit, the Debtor Will Retain an Interest Without Providing the Unsecured Creditors with Property of a Value Equal to the Allowed Amount of their Claims Contrary to the Express Language of §1129(b)(2)(B).

Under §1129(b)(2)(B), for a plan to be fair and equitable as to an unsecured class of creditors, the debtor's owners may not receive or retain on account of their

[10] The Plan may also be violative of §1129(a)(3), which requires that the plan be proposed in good faith. Where the court determines the value of the property under §506(a) based on information received from the debtor who is in control of the flow of information concerning the status of the property, and the debtor later proposes a plan under which the debtor's principals will be given the property for a price in excess of the court determined value, serious questions arise as to whether the good faith requirement has been met.

junior interests *any property* unless all members of a dissenting impaired unsecured class receive property equal to the full allowed amount of their claims.

The debtor's plan in the instant case provides that the debtor's prior owners retain their ownership interest in the debtor retaining the property while the dissenting unsecured class receives less than 10% of their claims. This is a clear violation of the provisions of §1129(b)(2)(B). The debtor's principals argue, however, that they are not retaining the property "on account of" their old ownership in violation of §1129(b)(2)(B)(ii), but are acquiring the interest for value, much as a third party could acquire the property by bidding for it. What the debtor ignores is that such acquisition, whether by the debtor or a third party bidder is not permitted under the Bankruptcy Code unless the interests of creditors are protected. The carefully drafted provisions of subsections (A) and (B) of §1129(b)(2) preclude such acquisition.[11] As

[11] In *Bonner Mall*, the Ninth Circuit transmogrifies the "new value exception" into the "new value principle" which –

> is an extra-statutory doctrine that specifically regulates the conditions under which plans calling for an infusion of capital by old equity in exchange for participation in a reorganized debtor may be confirmed in a cramdown.

2 F.3d at 910, n. 25. The Ninth Circuit acknowledges that "such a statutory exception does not exist." *Id.* Yet, it eagerly embraces as well-established law the concept of a cramdown plan – a lender's worst nightmare – by a route not specified by Congress when it defined fair and equitable treatment. The upshot of the Ninth Circuit's decision will be that any party unhappy with the limitations of the present Bankruptcy Code will rummage through repealed laws hoping to find some helpful doctrine. The requirements of a fair and equitable plan have been pain-

discussed above, the undersecured mortgage must equal the value of the collateral. A bid by a third party or by the debtor would determine the property value and raise the amount due under the mortgage. In other words, no plan under which the debtor or a third party keeps the property without compensating creditors in full may be confirmed over the objection of the unsecured creditor's class.

Thus the attempt to reformulate and apply the "new value exception" to cases involving undersecured mortgages on single asset properties is prohibited by the express provisions of the Bankruptcy Code.

IV. The Application of the "New Value Exception" to Single Asset Real Estate Reorganizations Serves No Public Purpose and Abrogates the Protection for the Mortgagee Built into the Bankruptcy Code.

A. No Public Purpose.

The application of the "new value exception" is often urged as a matter of public policy in order to keep the debtor in business, preserve the going concern value and keep people employed. While these objectives may be valid in connection with multi-asset reorganizations and industrial corporations, they are wholly inapplicable to single asset real estate cases.

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stakingly articulated by Congress and there is no need to resurrect judicially created exceptions to an earlier Act's undefined version of the fair and equitable standard which exception was not adopted by Congress.

In a single asset real estate transaction, the debtor's business is the operation of the real property, which is leased to tenants who occupy space in the building. Such operation of real estate will be continued no matter who is the owner of the property. It is a non-sequitur to say that the "reorganization will fail" if there is no infusion of new value. The only thing that may fail is the debtor's principals' attempt to keep the property without paying creditors. If the plan cannot be confirmed and no plan consistent with the language of the Bankruptcy Code can be proposed, liquidation will follow and the mortgagee or other purchaser will acquire and operate the property. Tenants will still occupy space in the property; the tenants' employees will continue to be employed in the premises; whoever operates the property will continue to employ maintenance and other personnel. The question is not whether the business will continue. The question is only who will own the property – the debtor's principals who have not paid the debtor's obligations to creditors, or the creditors who have not been paid by the debtor. The decision below grants exclusive control and any appreciation rights to the debtor's principals.

B. Abrogation of Mortgagee Protection.

1. Absolute Priority.

The Ninth Circuit ignores the intent of Congress that reorganization plans be confirmed only if they are "fair and equitable" as to dissenting impaired classes. The plan at issue in the instant case is impermissibly unfair and inequitable with respect to the dissenting creditor class.

The debtor's principals are permitted to retain the mortgaged property in exchange for only a $200,000 capital contribution while the dissenting creditor is forced to accept a pro-rata distribution of 300,000 shares of preferred stock in the new enterprise, which would be valued at $1 per share, in full satisfaction of its deficiency claim of approximately $3.4 million. In addition, the dissenting creditor will receive no interest in the property. This turns the concept of "risk capital" on its head since only the lender permanently loses value.

This Court has held that the dissenting creditor's interest in the debtor is a property right. *Northern Pacific Railway Co. v. Boyd, supra,* 228 U.S. at 508. In the instant case, U.S. Bancorp's property rights have been violated by the plan which permits the transfer of the property to the debtor's principals. The statutory framework set up by Congress requires that such decisions be negotiated by the debtor with its creditors. The absolute priority rule of §1129(b) is the basic ground rule for that negotiation process. It levels the playing field between the debtor's management, which controls the enterprise and its assets, and the debtor's creditors who, if the debtor is insolvent effectively own the enterprise. *See In re Outlook/Century Ltd., supra,* 127 B.R. at 650.

Absolute priority is of critical importance to the mortgage lending industry. Absolute priority for the unsecured portion of the mortgagee's claim (the claim of the mortgagee in excess of the value of the collateral as determined under §506(a) of the Bankruptcy Code) is the linchpin in the package of protection designed by Congress to protect the mortgagee from attempts by the debtor's principals to keep the property without paying creditors.

A major purpose of §1129(b)(2)(B) was to overcome the so-called *Pine Gate* line of cases that treated non-recourse mortgagees as the Ninth Circuit treats all mortgagees. *See In re Pine Gate Associates, Ltd.,* 2 Bankr. Ct. Dec. (CCH) 1478 (Bankr. N.D.Ga. 1976). Those cases under Chapter XII of the former Bankruptcy Act allowed borrowers to retain the mortgaged property while paying the non-recourse mortgagee the depressed value of the collateral, leaving such mortgagee with no compensation for the amount of the debt exceeding the property value, no control of the property, and no appreciation potential. *Bonner Mall* produces similar but harsher consequences for mortgagees since under *Bonner Mall* the mortgagee receives in lieu of cash equal to the value of the collateral, only a reduced mortgage in an amount determined by the court to be equal to the value of the collateral and deferred payments that the court has determined have a present value equal to the value of the collateral.

To overcome the *Pine Gate* inequity, Congress specifically provided in §1111(b)(1) of the Bankruptcy Code that every undersecured mortgagee would be able to have an unsecured claim for the debt in excess of the property value, and that the dissenting, impaired unsecured class would be afforded absolute priority. Thus, the debtor would not be able to retain the property while unsecured debts remain unpaid.[12]

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[12] *See* 5 Collier On Bankruptcy, ¶ 1111.02[2] (L. King 15th ed. 1986); L. Cherkis, Collier Real Estate Transactions and the Bankruptcy Code,¶ 1.11 (L. King ed. 1985); Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative,* 39

Under the *Pine Gate* line of cases, secured creditors willing to take the collateral in satisfaction of the debt were not permitted to do so. The plan would be confirmed and the secured creditors paid the value of their collateral which might be significantly less than their debt.[13] Due to the non-recourse nature of the debt, the secured creditors would not have had an unsecured claim for their loss.[14]

2. Treatment of Absolute Priority Under the Bankruptcy Code

As a direct response to the inequity of the *Pine Gate* line of cases, Congress was asked to restore absolute priority to real estate arrangements and to overrule *Pine Gate*.[15] Congress responded. It enacted a series of complex provisions as part of the Bankruptcy Reform Act of

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BUS. LAW. 441 (1984); and S. Rep. No. 989, 95th Cong. 2d Sess. 65, *reprinted in* 1978 U.S. CODE CONG. ADMIN. NEWS 5851 (commenting on Section 502(i) in an earlier version of Section 1111(b)).

[13] See *In re KRO Assoc.*, 4 Bankr. Ct. Dec. (CCH) 462 (Bankr. S.D.N.Y. 1978), where there were approximately $14 million in mortgages on the property and the court found the value of the property to be $895,000.

[14] While in *Bonner Mall* the mortgagee has an unsecured claim, the decision renders that claim of little value because it does not afford it absolute priority. Thus the result under *Bonner Mall* is similar to *Pine Gate*.

[15] See, e.g., Testimony of John J. Creedon on behalf of the American Council of Life Insurance, Hearings on S.2266 and H.R. 8200 Before the Subcommittee on Improvements in the Judicial Machinery, Senate Committee on the Judiciary, 95th Cong., 1st Sess. 853, 855-56 and 864-67 (1977).

1978 designed to protect the undersecured creditor by overcoming the *Pine Gate* rule. This package of protection included §§506(a), 1111(b) and 1129(b)(2). Together they insure that (i) the mortgagee may have a secured claim for the value of the collateral and an unsecured claim for the difference between the value and the amount of the indebtedness, and (ii) absolute priority for each of these claims.[16]

By effectively reading absolute priority for the unsecured claim out of §1129, the Ninth Circuit's decision undermines this Congressional package of mortgagee protection. The knot of protection for the mortgagee is tied with the absolute priority requirement for the unsecured claim. Under §1129(b)(2)(B), the dissenting impaired unsecured class must receive property of a value equal to the allowed amount of its claims before any junior interest receives any property.

Of course, there may not be property available to pay the unsecured claim in full. However, the debtor will not be able to retain its interest in the property unless such

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[16] Specifically, this package was designed to protect the mortgagee in the following manner:
Section 1111(b) provides that a non-recourse claim will be converted to a recourse claim for the purpose of plan confirmation (unless a fully secured claim is elected under §1111(b)(2), not germane here) thus assuring that the non-recourse mortgagee will have a claim for the unsecured portion of the debt as determined under §506(a). Section 1129(b)(1) requires absolute priority for every class that is impaired and has not accepted the plan. Thus, whether a mortgage is recourse, or has been converted to a recourse claim, the mortgagee has absolute priority for both the secured and unsecured claim (assuming the unsecured class rejects the plan by the requisite majority).

debts are so paid. If the debtor in *Bonner Mall* is permitted to keep the property without fully paying unsecured claims, the foundation of mortgagee protection will have been removed from the Bankruptcy Code, and the mortgagee will have been relegated to a situation even more harmful than under *Pine Gate*. This result would impermissibly expand the "new value exception" and contravene both the intention of Congress and the express language of the Bankruptcy Code.[17]

V. If the Ninth Circuit's Decision is Allowed to Stand, It Would Have a Severe and Negative Impact on Borrowers, Lenders and the Real Estate Industry.

If not reversed, the decision below will have a severe adverse impact on the real estate industry. Literally billions of dollars of insurance policyholders, bank depositors, pensioners, trusts and mortgagees have been loaned to borrowers on the strength of real property collateral and the protection built into the Bankruptcy Code. These Bankruptcy Code provisions were written to protect lenders whose rights were seriously jeopardized by the *Pine Gate* rule and to mandate priorities not in the former Bankruptcy Act.

The decision below can only result in tighter credit standards and higher interest rates for borrowers. It not only threatens existing mortgage debt held by lenders,

[17] See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 205 (1988), where this Court stated: "Even if Congress meant to retain the *Los Angeles Lumber* exception . . . it is clear that Congress had no intention to expand that exception any further."

but also threatens the future of the real estate industry, which relies so heavily on mortgage financing.

The Bankruptcy Code was carefully drafted by Congress to balance the interests of debtors and creditors and provide for the efficient administration of bankruptcy in the United States. If Courts are permitted by judicial legislation to undermine the foundations of the protection afforded to real estate mortgagees, the real estate industry and with it the national economy, will be severely and adversely affected.

CONCLUSION

For all of the reasons set forth herein, the American College of Real Estate Lawyers respectfully urges this Court to reverse the decision of the Ninth Circuit below.

Respectfully submitted,

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February 18, 1994

VIA FACSIMILE

Chris Graham, Esq.
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Re: In re Bonner Mall Partnership – Supreme Court #93-714

Dear Mr. Graham:

Pursuant to Rule 37.3 of the Rules of the Supreme Court, we hereby grant consent to you to appear as *amici curiae* in the above-referenced case.

Very truly yours,

/s/ Bradford Anderson
Bradford Anderson

A significant disadvantage to obtaining equity cushion capital from either creditors or outside investors is that these approaches offer no benefit to the existing owners of the insolvent company, who lose control in the reorganized company. In many cases, the existing owners may be familiar with the business operations and have been involved in managing the company; thus, the reorganized company may be disadvantaged by the loss of their association with it.

A more serious problem with these approaches is that they offer the owners no reason to initiate the reorganization process. If the company's owners have no incentive to file a reorganization proceeding, they will be inclined to seek delay and to take increasingly risky gambles hoping that solvency will be restored eventually through some miracle. This is likely to lead to further financial deterioration, to the point where recovery is no longer possible. In theory, the insolvent company's creditors can file involuntary Chapter 11 proceedings if the owners fail to do so. But in practice, creditors do not have ready access to the company's financial information, and initiating an involuntary proceeding is difficult and risky for them. *See* Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 Int'l Rev. L. & Econ. 223 (1991).

An additional justification for allowing participation by the former owners in the reorganized company is that they may be the best source of new capital. *See Northern Pacific Railway v. Boyd*, 228 U.S. 482, 495 (1913). Unless the owners are allowed to provide new capital for the reorganizing company, the reorganization may fail and the creditors could wind up receiving less in liquidation than they would have under the plan. If the absolute priority

rule bars contributions of new capital from an insolvent company's owners, it could be detrimental to the interests of the very unsecured creditors it was designed to protect.

Contributions of new capital from an insolvent company's former owners should be encouraged, rather than barred. Accordingly, this Court should recognize the new capital exception to the absolute priority rule. At the same time, the Court should require the form and amount of the capital contributions to be sufficient to fulfill the purpose of the Chapter 11 reorganization process by restoring financial health to the reorganized company.

III. The Form of the Capital Contribution

In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), this Court addressed the form required for a capital contribution if the new capital exeception were to be recognized. Following *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 121-22 (1939), the Court held that capital contributions would have to be in the form of "money or money's worth."

The reorganization plan in *Los Angeles Lumber* called for contributions from the reorganizing corporation's former shareholders that consisted merely of their "financial standing and influence in the community" and their providing "continuity of management." *Id.* at 122. The Court held that these intangibles were not adequate consideration for the issuance of stock in the reorganized corporation, saying: "On the facts of this case they cannot possibly be translated into money's worth reasonably

equivalent to the participation accorded the old stockholders. They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities." *Id.* at 122-23 (footnote omitted).

The reorganization plan in *Ahlers* called for "yearly contributions of labor, experience, and expertise," 485 U.S. at 201, from the owners of a farm. As in *Los Angeles Lumber*, the Court decided that these contributions of future services were not sufficient to justify an exception from the absolute priority rule. It reasoned:

> Viewed from the time of approval of the plan, respondents' promise of future services is intangible, inalienable, and in all likelihood, unenforceable. It "has no place in the asset column of the balance sheet of the new [entity]." *Los Angeles Lumber*, 308 U.S., at 122-23. Unlike "money or money's worth," a promise of future services cannot be exchanged in any market for something of value to the creditors *today*. In fact, no decision of this Court or any Court of Appeals, other than the decision below, has ever found a promise to contribute future labor, management, or expertise sufficient to qualify for the *Los Angeles Lumber* exception to the absolute priority rule.

Id. at 204 (emphasis in original) (footnote omitted).

In *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1362-63 (7th Cir. 1990), the Seventh Circuit confronted a type of capital contribution similar to one offered in the reorganization plan in this case: a shareholder guarantee of a loan to the reorganizing corporation. The plan of reorganization provided for the

corporation's former shareholders to retain ownership of the corporation in return for their guaranteeing new loans that would finance the reorganization. *Id.* at 1354.

Relying on *Ahlers* and *Los Angeles Lumber*, the Seventh Circuit ruled that the guarantees could not constitute new value for purposes of satisfying a new capital exception to the absolute priority rule. Judge Easterbrook's opinion for the court pointed out that guarantees are not balance-sheet assets; instead, guarantees are intangible, inalienable, and unenforceable, because there is no way for a corporation to prevent shareholders from revoking their guarantees or rendering them valueless by disposing of their assets. The court also noted that persons organizing a new corporation in Illinois could not issue stock to themselves in return for guarantees of loans, because Illinois law restricts the consideration for new shares to money, property, or past services. *Id.* at 1362.

The Seventh Circuit made a useful comparison in the *Kham & Nate's Shoes* decision between on the one hand, the problem of the form of new capital contributions in the corporate reorganization context, and on the other, the problem of "watered stock" and the form of capital contributions required as consideration for the issuance of stock under general corporate law. For many decades, the trend in corporate law has been in the direction of increasing liberalization of the form of allowed capital contributions. 1 Model Business Corp. Act Ann. § 6.21 history (3d ed. 1989); 1 Model Business Corp. Act Ann. § 19 comment (2d ed. 1971). The Model Business Corporation Act (2d ed. 1971) provided:

> The consideration for the issuance of shares may be paid, in whole or in part, in money, in other property, tangible or intangible, or in labor or services performed for the corporation. . . .
>
> Neither promissory notes nor future services shall constitute payment or part payment for the issuance of shares of a corporation.

1 Model Business Corp. Act Ann. § 19 (2d ed. 1971).

The Revised Model Business Corporation Act (3d ed. 1989) broadens the allowable consideration to "any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation." 1 Model Business Corp. Act Ann. § 6.21 (3d ed. 1989). The Official Comment to Section 6.21 explains:

> Section 6.21(b) specifically validates contracts for future services (including promoters' services), promissory notes, or "any tangible or intangible property or benefit to the corporation," as consideration for the present issue of shares. . . . In the realities of commercial life, there is sometimes a need for the issuance of shares for contract rights or such intangible property or benefits. And, as a matter of business economics, contracts for future services, promissory notes, and intangible property or benefits often have value that is as real as the value of tangible property or past services, the only types of property that many older statutes permit as consideration for shares.

Whether intangible property should be a permissible form for a new capital contribution in a bankruptcy reorganization should depend on the applicable state corporate law. *See Butner v. United States*, 440 U.S. 48, 55 (1979) (in the absence of an overriding federal interest, property rights in bankruptcy proceedings should be determined by reference to state law). Thus, if the applicable state law would permit a promise of future services (as in *Ahlers*) or a shareholder guarantee (as in *Kham & Nate's Shoes* or this case) to constitute allowable consideration for the issuance of stock in a corporation, then these forms of intangible property should be permissible as capital contributions, whether they come from a former shareholder or an outside investor. Most states (including Idaho), however, continue to follow Section 19 of the Model Business Corporation Act (2d ed. 1971) and prohibit the issuance of shares in exchange for such forms of intangible property. *See* 1 Model Business Corp. Act Ann. § 6.21 annot. at 370-71 (3d ed. 1989) (listing states).

IV. The Amount of the Capital Contribution

The prevailing standard for the amount of the new capital contribution in a plan of reorganization comes from the following dictum in *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 122 (1939): "[T]he stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." Because the shareholders' contribution in that case was not "in money or in money's worth," it was not in the proper form, and the Court did not decide whether it was "reasonably equivalent" to the value of the equity the shareholders were to receive under the plan. Thus, the

Court's statement concerning the amount of the new capital contribution was not part of the holding.

Although this standard appears reasonable, it provides no real guidance to courts, because it is a tautology. *See* Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 Stan. L. Rev. 69, 96-101 (1991). Under the absolute priority rule, all of an insolvent company's value must be allocated to its creditors; any debt in excess of its value as a going concern is discharged. When new capital is contributed, the *Los Angeles Lumber* dictum will be satisfied as a matter of course, because the only value not allocated to the creditors is the new capital contribution. As Professor Markell notes, rather than placing any limits on the new capital exception to the absolute priority rule, the *Los Angeles Lumber* standard "merely rephrases the . . . rule." *Id.* at 101.

In order to repair an insolvent company's capital structure in the course of the reorganization process, its liabilities must first be written down to the going concern value of the assets. At that point, the going concern value of the company's assets net of its liabilities is zero. The going concern value of the company's assets net of liabilities may not be greater than zero, because if it were, the creditors would be entitled to the excess as a result of the absolute priority rule. A contribution of new capital to the reorganizing company causes its going concern value net of its liabilities to increase precisely by the amount of the contribution. Since the contribution will always be equivalent to the resulting going concern value net of liabilities, the amount of the capital contribution that is required in the reorganization process cannot be determined from the company's going concern value.

The indeterminacy of the *Los Angeles Lumber* standard may be demonstrated with a numerical example. Consider the balance sheet of a company that initially has assets with a going concern value of $1 million and liabilities of $3 million. Writing down the liabilities to $1 million (the going concern value of the assets) would yield a net going concern value of zero. If an owner or other investor were to make a capital contribution of as little as $5,000 after the writing down of the liabilities, the going concern value of the company's assets after the contribution would be $1,005,000 and its net going concern value would be $5,000. This is illustrated below.

Before Reorganization

Assets	$1,000,000	Liabilities	$3,000,000
		Equity	-2,000,000
Total	$1,000,000		$1,000,000

After Reorganization

Assets	$1,000,000	Liabilities	$1,000,000
Shareholder Contribution	5,000	Equity	5,000
Total	$1,005,000		$1,005,000

An owner's contribution of new capital does not vanish when it is made; instead, it increases the going concern value of the reorganized company. The increase in going concern value resulting from the infusion of new capital may be even larger than the amount of the new capital contribution, and over time, the participation of former owners may contribute to the company's going

concern value, particularly if they are involved in the company's management or operations.

Since the *Los Angeles Lumber* standard is fundamentally unsound, it should be replaced with a better standard that is consistent with the purpose of the Chapter 11 reorganization process. The most appropriate criterion for the size of the new capital contribution is that it should be sufficient to provide an adequate equity cushion. The price that the new owners of a reorganized business should be required to pay for control following the reorganization is neither the going concern value (which will initially be zero if the company's assets are valued correctly and the absolute priority rule is applied) nor the amount of liabilities that are to be discharged. Instead, the price should be that the new owners must put up a sufficient stake in the enterprise to absorb any future losses that can reasonably be anticipated, thus reducing the risks to the creditors.

Absolute protection for a company's creditors is not attainable. No business is entirely risk free, and there is always some possibility of future losses to creditors that cannot be eliminated with any finite amount of equity capital. Although creditors cannot expect to receive absolute protection, they can be shielded from most risk of loss through the maintenance of an adequate cushion of equity. An adequate cushion of equity means the company's owners will have appropriate incentives to maximize the long term value of the company, whether the equity cushion comes from outside investors or from former owners. The equity cushion ought to be large enough, not only to keep the potential conflicts of interest between owners and creditors to a minimum, but also to absorb any fluctuations in earnings that can reasonably

be anticipated. Otherwise, there is too great a risk of another insolvency, and the reorganization will have been for naught.

To protect the company's existing and future creditors from a second insolvency, the "feasibility requirement" in section 1129(a)(11) of the Bankruptcy Code provides that a bankruptcy court should confirm a reorganization plan only if confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor." This requirement has long been a part of the law of bankruptcy reorganizations. To determine whether a plan satisfies the feasibility requirement, the courts normally look at whether there is a reasonable prospect for the reorganization plan to be successful. While the adequacy of a debtor's capital structure is often listed as one of the factors used in analyzing a plan's feasibility, the bankruptcy courts have tended to concentrate more on the accuracy of the plan's income projections than on the need for the owners of the reorganized company to have a significant stake in the enterprise.

The feasibility requirement cannot be satisfied if the reorganized business is so thinly capitalized that it is unable to withstand some future losses. The largest possible equity cushion would be provided by an all-equity capital structure, but most companies operate satisfactorily with substantial levels of debt. The presence of debt increases risk, but the reorganized company obtains offsetting benefits from the tax advantages and leverage that debt financing provides. And subject always to the stability of the expected earnings for the reorganized company, the risk of insolvency following reorganization can be

held to an acceptable level by maintaining an adequate equity cushion.

A variety of factors may potentially influence a company's capital structure. These include the company's profitability, the uniqueness of its products, the degree of specialization of its equipment and its employees, and the extent of equity ownership by its management. *See* Milton Harris & Artur Raviv, *The Theory of Capital Structure*, 46 J. Fin. 297, 337-40 (1991) (summarizing theoretical and empirical studies on the effect of these and other factors on a corporation's capital structure). However, the primary factor affecting a company's capital structure is generally the volatility of its earnings. A number of studies have shown, for example, that corporations in regulated industries, which tend to have stable earnings, have the highest proportions of debt, while pharmaceutical and electronics manufacturers, which tend to have volatile earnings, have the smallest proportions of debt. *Id.* at 333-35. Therefore, the capital structures of other companies in the same industry may provide a gauge for a bankruptcy court to use in evaluating the adequacy of a proposed equity cushion in a reorganization plan. *Cf.* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 Cornell L. Rev. 597, 607-09 (1993) (companies emerging from reorganizations tend to have higher debt-to-equity ratios than companies of comparable size in the same businesses).

Although there may not be any precise formula for determining an ideal capital structure for a reorganized company, in many cases a bankruptcy court can be reasonably certain that a capital structure proposed in a plan under review is inadequate. For example, it is clear that a

business should not be allowed to emerge from the reorganization process without any equity cushion. For closer cases, the bankruptcy court may need expert testimony from a financial analyst concerning the adequacy of capitalization and possibly also from a lender as to the likelihood of the debtor being able to borrow the debt provided for in the plan from an informed outside source. *See In re Mobile Steel Co.*, 563 F.2d 692, 703 (5th Cir. 1977) (listing methods for determining the adequacy of capitalization in equitable subordination cases).

The adequacy of the capital contribution proposed in this case is addressed below.

V. Application to the Facts of This Case

In this case the debtor's primary asset is a shopping mall in Idaho, which the bankruptcy court valued at $3.2 million. Its major liability is a loan of $6.6 million secured by a deed of trust against the mall. The debtor's plan provides for repayment of the secured portion of the loan ($3.2 million) 32 months after confirmation with interest payable monthly in the interim. Unsecured creditors with claims greater than $1,000 will receive a *pro rata* distribution of 300,000 shares of preferred stock, which has a par value of $1.00 per share and is convertible to a maximum of 300,000 shares of common stock upon repayment of the secured portion of the loan. The preferred shares will have a liquidation preference over the common stock. The debtor's six former partners together are to contribute cash of $200,000 and will receive 2 million shares of common stock in return. In addition, the plan calls for the partners to subsidize any shortfall in working capital during the first 32 months after confirmation of the plan

and for five of the former partners to contribute a collateral trust mortgage on other property as a guarantee of the debts that are being assumed by the reorganized business. *See In re Bonner Mall Partnership*, 2 F.3d 899, 905 (9th Cir. 1993).

It is apparent that the reorganized corporation would be too thinly capitalized to satisfy the feasibility requirement. Even though the reorganized corporation would not be immediately insolvent if the plan were confirmed, the common shareholder's equity interest would be "under water" on account of the issuance of the 300,000 shares of $1.00 par value preferred stock to the corporation's former unsecured creditors. The issuance of the preferred shares would therefore violate the stated capital requirements of applicable Idaho law. *See* Idaho Code §§ 30-1-18, 30-1-21 (1980) (prohibiting the issuance of shares for less than their par value). With only a $200,000 equity cushion, the common shareholders would not be entitled to any profits until the $100,000 impairment of capital resulting from issuance of the preferred stock was cured. Consequently there is a potential conflict of interest between the common and preferred shareholders built into the capital structure of the reorganized corporation.

The *Bonner Mall* plan is also deficient on account of the size of the equity cushion. There are a number of factors that affect the size of a real estate loan, but most lenders require at least a 75% loan to value ratio:

> Since the beginning of the commercial mortgage business, lenders have imposed a 75% loan-to-value limit as being prudent. This real estate recession has unfortunately shown that even that level of leverage was too aggressive. As a result, a number of survey members are now requiring that their commercial mortgages meet a 65% loan-to-value test or less.

John B. Levy, *Regulations Prompt Higher Minimum Spreads*, 35 Nat'l Real Estate Investor 24 (Mar. 1993). *Cf.* 79 Fed. Reserve Bull. A37 (Sep. 1993) (loan-to-value ratios for mortgages on new homes ranged from 74.8% to 79.5% between 1990 and June, 1993). An appropriate equity cushion for the secured creditor's $3.2 million claim might therefore be in the neighborhood of $1 million, instead of the $200,000 called for in the reorganization plan.

The plan also calls for the former partners to subsidize any shortfall in working capital and to guarantee the payment of the reorganized corporations with a collateral trust mortgage. Depending on the circumstances, these guarantees might have sufficient value to compensate for the lack of a more substantial cash contribution. However, they would not be allowed as consideration for the issuance of new shares under applicable Idaho law. *See* Idaho Const. art. XI, § 9 ("No corporation shall issue stocks or bonds, except for labor done, services performed, or money or property actually received; and all fictitious increase of stock shall be void."); Idaho Code § 30-1-19 ("The consideration for the issuance of shares may be paid, in whole or in part, in cash, in other property, tangible or intangible, or in labor or services actually performed for the corporation."). Thus, they should not be considered part of the equity cushion of this reorganized corporation.

Accordingly, the reorganization plan does not satisfy the feasibility standard and should not be confirmed.

Even if this Court concludes that the record is not sufficiently clear to decide on confirmation of the reorganization plan, the Court should specify the standard clearly enough for the lower courts to apply. The standard should be based on the capital structure of the reorganized company having an equity cushion that is adequate to withstand reasonably foreseeable variations in future earnings. The adequacy of the equity cushion may be determined by comparison to the capital structures of similar businesses and from testimony of financial experts.

CONCLUSION

Inseparable from the issue of whether a new capital exception to the absolute priority rule should exist is the question of what its parameters should be. In addition to recognizing this exception, this Court should enunciate reasonable standards for the form and amount of the new capital required for confirmation of a reorganization plan.

Respectfully submitted,

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Amicus Curiae